United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7412

United States Court of Appeals

For the Second Circuit.

SYLVIA SACKS and BENJAMIN M. SACKS, individually as joint tenants, DONALD W. HAGELE, individually and as representatives and Class Members of Stockholders of INTERSTATE STORES, Inc., who purchased their shares subsequent to Christmas 1973, ROBERT G. MORRIS, individually, ROBERT G. MORRIS, MARIKAY MORRIS and J. BRECK TOSTEVIN, as Trustees for ROBERT G. MORRIS, DDS, Inc. EMPLOYEES PENSION TRUST, BABETTE KENT, individually, JEROME KENT and BABETTE KENT as joint tenants, JEROME KENT, individually, and MORRIS L. JANOVITZ, individually and as representatives and Class Members of Bondholders of INTERSTATE STORES, Inc., who purchased their bonds subsequent to Christmas 1973, and in behalf of all other persons similarly situated and circumstanced,

Plaintiffs-Appellants,

against

INTERSTATE STORES, INC., SOL W. CANTOR, S. D. LEIDESDORF & CO., a partnership, MERSHULAM RIKLIS, HERBERT B. SIEGEL, CHARLES P. LAZARUS, ALBERT PARKER, SAM J. ABEND, WALTER A. CRAIG, SAMUEL HAUSMAN, M. LESTER MENDELL, EDWARD C. SCHENKEL, HAROLD J. SZOLD, ROBERT C. VAN TUYL, and "JOHN DOE" and "RICHARD ROE", the names "JOHN DOE" and "RICHARD ROE" being fictitious, the parties intended being those individuals, firms, corporations and associations who obtained material nonpublic information to the effect that in Christmas 1973 the said INTERSTATE STORES, Inc., was "devoid of credit" and who either utilized this information for its own account or transmitted it to third parties who utilized this information for their own account,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NEW YORK.

Brief for Defendants-Appellees, Sol W. Cantor and Herbert B. Siegel.

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United States Court of Appeals

FOR THE SECOND CIRCUIT.

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Defendants-Appellees.

Brief for Defendants-Appellees, Sol W. Cantor and Herbert B. Siegel.

Issues Presented

The issues presented in this appeal are as follows:

1. Whether the court acted properly in finding that the amended complaint, alleged almost entirely upon information and belief without stating the grounds for the belief, fails to meet the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure ("FRCP").

2. Whether, absent insider or "tippee" trading, the failure of a public corporation to promptly disclose to the public that the normal credit terms given by suppliers to customers were cut off, is, without more, a violation of the securities laws.

3. Whether the court acted properly, as a matter of law, in dismissing the amended complaint herein without granting plaintiffs leave to replead, where plaintiffs failed to show that an amended complaint would cure the defects of the prior complaint.

Nature of the Case

This is a purported class action to recover damages for alleged violations of Sections 9, 10(b), 13, 15, 18 and 20 of the Securities and Exchange Act of 1934 ("Exchange Act"); Securities and Exchange Commission ("SEC") Rule 10b-5 and items 4, 6 and 13 of the SEC Form 8-K; and common law fraud and deceit. Plaintiffs, who bring this action on behalf of themselves and all other persons similarly situated,* comprise two groups: purchasers of

*No motion has been made by any of the parties with respect to whether plaintiffs may maintain the instant action as a class action.

shares of Interstate Stores, Inc. ("Interstate") subsequent to Chrismas 1973, [Amended Complaint, paragraph (hereinafter "Am. Compl., par. ") 27, Appellants' Appendix (hereinafter "A. ") 15] and purchasers of 4% Convertible Subordinated Debentures of Interstate subsequent to the same date (Am. Compl., par. 33, A.17-18).**

The defendants are Interstate, Sol W. Cantor ("Cantor"), Herbert B. Siegel ("Siegel"), Charles P. Lazarus, Albert Parker, Sam J. Abend, Walter A. Craig, Samuel Hausman, M. Lester Mendell, Edward C. Schenkel, Harold J. Szold and Robert C. Van Tuyl, directors and alleged controlling persons of Interstate; S. D. Leidesdorf & Co. ("Leidesdorf"), independent auditors for Interstate; Meshulam Riklis; and "John Doe" and "Richard Roe", fictitious names used to represent those alleged to have been "tippee" traders in Interstate common stock or debentures.

Plaintiffs' claims are brought in four counts. In Count One, brought on behalf of common stock purchasers, defendants' alleged derelictions, as more fully analyzed below, are said to give rise to violations of Sections 9, 10(b), 13, 15, 18 and 20 of the Exchange Act and Rule 10b-5 and items 4, 6 and 13 of the SEC Form 8-K. In Count Two, brought on behalf of debenture purchasers, the same facts are said to give rise to the same violations. Counts Three and Four, brought on behalf of both sets of plaintiffs, incorporate the same facts which are here said to give rise to claims for common-law fraud and deceit.

**On May 22, 1974, Interstate filed a proceeding for an arrangement in bankruptcy under Chapter II of the Bankruptcy Act. (The complaint mistakenly alleged that the proceeding was commenced in May 1973, Am. Compl., pars. 22, 37, A. 12, 19.)

Course of the Proceedings

This action was commenced by the filing of the original complaint herein on June 12, 1974 (A.2).* Thereafter, defendant Cantor moved, *inter alia,* to dismiss the complaint pursuant to Rule 12(b)(6) of the FRCP for failure to meet the minimal pleading requirements of Rule 9(b) of the FRCP (A.3). Prior to the return date of this motion, plaintiffs withdrew their complaint and served an amended complaint (A.3).** Defendant Cantor thereupon withdrew his motion.

The amended complaint closely paralleled the original complaint with certain minor changes, including a statement of the dates of plaintiffs' purchases and the deletion of certain material. Cantor again moved to dismiss, pursuant to Rule 12(b)(6) of the FRCP, again asserting, *inter alia,* that the pleading failed to meet the minimal requirements of Rule 9(b) of the FRCP (A.3). Defendant Siegel thereafter joined defendant Cantor's motion to dismiss (A.3).

The motion was heard by Judge Walter Bruchhausen on June 20, 1975 (A.3) and a memorandum decision, dated June 23, 1975 (A.28-29) was rendered dismissing the amended complaint for "utterly" failing to comply with Rule 9(b) of the FRCP in that the amended complaint

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*The only defendants who appeared in response to the original complaint were Cantor, Leidesdorf and the Bank of New York (A. 2-3). The claim against the Bank of New York was dismissed on stipulation after it had moved to dismiss the complaint (A. 2).

**The only defendants who appeared in response to the amended complaint were Cantor, Siegel and Leidesdorf (A. 3). The claim against Leidesdorf was dismissed by agreement between Leidesdorf and plaintiff.

"alleges nothing more than sheer speculation that the actions of the defendants constituted violations of the security laws, rules and regulations." Judge Bruchhausen further stated that "[I]t is apparent from a reading of the amended complaint that little investigation or research has been conducted prior to the filing of the pleadings." By order dated July 2, 1975, the amended complaint was dismissed without leave to amend and the within action dismissed with prejudice (A.4).

Statement of the Facts

The substantive allegations of the amended complaint, which in essence charge defendants with fraud,* are stated in vague, conclusory terms without any specific factual allegations. Moreover, nearly all of the allegations of wrongdoing are made upon information and belief although the facts upon which the belief is founded are not stated.** Thus, the amended complaint alleges: (i) about December 1973, the trade credit of Interstate which involved, on *information and belief*, all of the

*Although the amended complaint names several sections of the securities laws, plaintiffs concede that Count One which asserts plaintiffs' basic claim includes a "common or garden" Rule 10b-5 claim. [Appellants' Brief, page 3 (hereinafter "Appellants' Br., p. ").]

**It is cryptically stated that "these violations" were discovered in the course of a court hearing before Judge Cannella (Am. Compl., par. 26, A.14-15), but, significantly, plaintiffs fail to allege the statements made at the hearing, i.e., the *facts* upon which their belief is founded. In one instance, the source is identified. It is alleged that defendant Siegel stated in court during Interstate's bankruptcy proceedings that Interstate became "devoid of credit" prior to Christmas, 1973. (Am. Compl., par. 15, A.13). The meaning of this obviously ambiguous term is, however, alleged upon information and belief without stating the facts upon which the belief is founded.

normal credit terms given by suppliers to customers, was cut off, so that Interstate was put on a "C.O.D." basis by its suppliers (Am. Compl., par. 15, A.13); (ii) the defendant Leidesdorf knew or should have known about Interstate's loss of trade credit but failed to report this fact on an SEC Form 8-K (Am. Compl., par. 16, A.13); (iii) Interstate's loss of trade credit was material information which should have been promptly disclosed to the public (Am. Compl., par. 17, A.13); (iv) *on information and belief* defendants did not make this information "generally known to the public" but instead "tipped" the information to third parties, who, as a result, sold their Interstate stocks and bonds (Am. Compl., par. 19, A.12-13); (v) *on information and belief* defendant Riklis knew that Interstate had lost its trade credit and directly or indirectly sold Interstate securities (Am. Compl., par. 20, A.12); (vi) *on information and belief* subsequent to December 1973 the defendants knew that a proposed merger with McCrory Corp. ("McCrory") would not take place but did not until considerably later report this to the public (Am. Compl., par. 21, A.12); (vii) although Interstate commenced Bankruptcy Proceedings in May 1974, *on information and belief* it was known by defendants as early as December 1973 that such proceeding would have to be commenced (Am. Compl., par. 22, A.12, 14); and (viii) *on information and belief* defendants "tipped" third parties as to this adverse information with respect to Interstate and as a result they sold a considerable volume of Interstate securities (Am. Compl., par. 23, A.14). (Emphasis supplied.)

Glaringly absent from the amended complaint are the type of factual allegations, as opposed to suppositions and conclusions, upon which a securities fraud claim must be based. Thus, an essential element of plaintiffs' claims, that defendants "tipped" third parties who then traded on this inside information,* is alleged upon an

*See *infra* at pp. 19-22 as to the necessity of alleging insider or "tippee" trading.

information and belief which is not buttressed by the facts upon which the belief is founded (Am. Compl., par. 23, A.14). Significantly, although plaintiffs do not state the facts upon which their belief is based, they do state, as a conclusion, that the violations alleged in the amended complaint were discovered in the course of a court hearing before Judge Cannella of the Southern District of New York on June 6, 1974 (Am. Compl., par. 26, A.14-15). Yet, the transcript of this hearing is a matter of public record and the transcript does not even remotely allude to the existence of "tippee" trading with respect to Interstate securities.**

Similarly, the claims that defendants withheld material information from the public as to Interstate's proposed merger with McCrory's (Am. Compl., par. 21, A.12) and Interstate's institution of bankruptcy proceedings (Am. Compl., par. 22, A.12) are alleged on information and belief. No facts are stated to support these conclusions. Moreover, the alleged source of plaintiffs' conclusions, the court hearing before Judge Cannella, does not even intimate the existence of facts to support the conclusions.

The amended complaint also alleges that Interstate lost its trade credit about Christmas 1973 (Am. Compl., par. 15, A.13), and that defendant Leidesdorf was required to file a SEC Form 8-K as to this event (Am. Compl., par. 16, A.13). This allegation is not directed against defendants Cantor and Siegel, but is directed solely against former defendant Leidesdorf. However,

**The matter is entitled *In the Matter of: Interestate Stores, Inc., formerly known as Interestate Department Stores, Inc.*, 74 B 614. The transcript of the court hearing, referred to by plaintiffs and previously submitted to Judge Bruchhausen on the return of the motion to dismiss the amended complaint, will be delivered to the Court on the return date of this appeal.

it is clear that the claim could not be sustained against Cantor and Siegel, since there is no requirement that such information must, as a matter of law and irrespective of "tippee" or insider trading, be promptly disclosed to the public. Nor is there a rule that absent "tippee" or insider trading, failure to disclose such information gives rise to a claim for damages against corporate officers and directors.

Plaintiffs further assert on this appeal that even if their amended complaint is fatally defective they have a right, as a matter of law, to replead. In the motion below, however, plaintiffs, apparently recognizing that their amended complaint was fatally defective, attempted to salvage their action by requesting, in the form of an affidavit by plaintiffs' counsel, leave to amend so that plaintiffs might assert "additional detail." A.25-27. The crux of the "additional detail" was stated to be that,

> "In January 1974 the volume of sales of securities of Interstate Stores, Inc. was far in excess of the normal trading volume. *Thus, obviously, the information involved herein was communicated to favored third parties.*" (A.26). (Emphasis added.)

The absurdly defective logic underlying this assertion only serves to underscore the defects of the instant action and makes manifest that granting leave to replead will only engender further waste of time and expense.*

*Plaintiffs also assert in their request for leave to replead that discovery has been denied them in that "interrogatories addressed to the defendants have not been answered." (Appellants' Br., p. 6.) The assertion that there are unanswered interrogatories is also made in Appellants' Br., p. 8. The implication that defendants have refused or failed to answer interrogatories and have thereby hindered discovery, is, however, false. Defendant Siegel has, in fact, never been served with interrogatories. As

As a result of the foregoing, it is respectfully submitted that the court below was correct in dismissing the amended complaint herein and in not granting leave to replead.

POINT I

The amended complaint is fatally defective in that it fails to meet the pleading requirements of Rule 9(b) of the FRCP.

The amended complaint, the gravamen of which alleges fraud, was correctly dismissed below since it fails to meet the minimal pleading requirements of Rule 9(b) of the FRCP, which provides that:

> "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

The Second Circuit has on numerous occasions held that conclusory allegations of fraud will not suffice to state a claim under Rule 9(b). *Segan v. Dreyfus Corp.*, 513 F. 2d 695 (2nd Cir. 1975); *Felton v. Walston and Co., Inc.*,

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(footnote continued):
to defendant Cantor, counsel for plaintiffs himself signed a stipulation dated November 21, 1974 agreeing that the time for defendant Cantor to answer or object to plaintiffs' interrogatories is extended until "ten days after the determination of the said defendant's motion to dismiss the complaint or after the determination of any motion by said defendant pursuant to Rule 12 of the Federal Rules of Civil Procedure to dismiss any amended complaint or after the service by said defendant of its answer to any amended complaint, whichever is latest." The stipulation was made an order by Judge Bruchhausen and filed on November 26, 1974 (A. 3).

508 F. 2d 577 (2nd Cir. 1974); *Schlick v. Penn-Dixie Cement Corp.*, 507 F. 2d 574 (2nd Cir. 1974); *Segal v. Gordon*, 467 F. 2d 602 (2nd Cir. 1972); *Shemtob v. Shearson, Hammill & Co.*, 448 F. 2d 442 (2nd Cir. 1971); *O'Neill v. Maytag*, 339 F. 2d 764 (2nd Cir. 1964). See also *Rich v. Touche Ross & Co.*, CCH Fed. Sec. L. Rep. ¶95,084 (S.D.N.Y. 1975); *Goldberg v. Shapiro*, CCH Fed. Sec. L. Rep. ¶94,813 (S.D.N.Y. 1974); *Passerieux v. Time, Inc.*, CCH Fed. Sec. L. Rep. ¶94,805 (S.D.N.Y. 1974); *Lewis v. Varnes*, 368 F. Supp. 45 (S.D.N.Y.) aff'd 505 F. 2d 785 (2d Cir. 1974); *Zammas v. Jagid*, CCH Fed. Sec. L. Rep. ¶94,342 (S.D. N.Y. 1973); *Segal v. Coburn Corp. of America*, CCH Fed. Sec. L. Rep. ¶94,002 (E.D.N.Y. 1973); *Competitive Associates v. Firefly Enterprises*, 59 F.R.D. 336 (S.D.N.Y. 1972); *Matheson v. White Weld & Co.*, 53 F.R.D. 450 (S.D.N.Y. 1971).

The more stringent pleading requirement for fraud actions arises from a recognition of the pernicious potential of unsupported assertions of fraud. Rule 9(b)'s particularity requirement is thus an effective vehicle for eliminating fraud actions which are brought to find fraud rather than to redress a wrong reasonably believed to have occurred and thereby protecting defendants from this particularly odious form of pseudo-legal harassment. See *Segal v. Gordon, supra*, 467 F. 2d at 607-08; *Goldberg v. Shapiro, supra*, ¶94,813 at 96,717.* As stated in *Segal v. Gordon, supra*, 467 F. 2d at 607:

> "Rule 9(b)'s specificity requirement stems not only from the desire to minimize the number of

*In *Segan v. Dreyfus Corp., supra*, 513 F. 2d at 696, it was recently held that a defendant may not be subjected to discovery before plaintiffs state a well-pleaded claim of fraud. Clearly, a fishing expedition to discover fraud is anathema to the requirement that fraud be, in the first instance, stated with particularity.

strike suits but also more particularly from the desire to protect defendants from the harm that comes to their reputations or to their goodwill when they are charged with serious wrong-doing:

> "'It is a serious matter to charge a person with fraud and hence no one is permitted to do so unless he is in a position and is willing to put himself on record as to what the alleged fraud consists of specifically.'
>
> "In response to these considerations this Court and our lower courts have been sensitive to the requirement that the circumstances constituting fraud be alleged with particularity."

To insure that a proper investigation of the facts has occurred and that a wrong may reasonably be inferred from the facts uncovered, a plaintiff is put to the minor burden of alleging the specific facts, as opposed to conclusions, that he has uncovered and which relate to the circumstances constituting the fraud. See, e. g., *Segal v. Gordon, supra*, 467 F. 2d at 607. Absent such specific factual averments "the allegations of wrongdoing are not supported; they remain bare assertions that impose on recited events a gratuitous imputation of misconduct . . ." *Segal v. Coburn Corp. of America, supra*, ¶94,092 at 94,019-20. See also *Goldberg v. Shapiro, supra*, ¶94,813 at 96,717. In sum, Rule 9(b) prohibits allegations unsupported by specific facts and amounting to nothing more than "unmitigated speculation." See *Segal v. Gordon, supra*, 467 F. 2d at 608.

Consequently, it is crystal clear that a plaintiff may not allege a claim of fraud upon information and belief without stating the facts upon which the belief is founded. See *Segal v. Gordon, supra*, 467 F. 2d at 608; *Duane v. Altenburg*, 297 F. 2d 515, 518 (7th Cir. 1962). See also *Arpet v. Homans*, 390 F. Supp. 908 (W.D. Pa. 1975);

Goldberg v. Shapiro, supra, ¶94,813 at 96,717; *Competitive Associates, Inc. v. Firefly Enterprises, Inc., supra,* 59 F.R.D. at 338; 2A J. Moore's Federal Practice ¶9.03 at 1928-29 (1975); 5 C. Wright and A. Miller, Federal Practice and Procedure: Civil §1298 at 416 (1969). Obviously, a claim made upon information and belief which is unsupported by specific facts amounts to nothing more than an extreme form of the "unmitigated speculation" Rule 9(b) is designed to prevent.

This Court continues to apply these standards of pleading in cases alleging securities fraud. Thus in *Schlick v. Penn Dixie Cement Corp., supra,* this Court sustained a complaint alleging a Rule 10b-5 claim upon information and belief where the complaint contained "a statement of the facts upon which the belief is founded." 507 F. 2d at 379. The Court also found that the complaint, which referred to specific acts of corporate mismanagement, alleged "a specific scheme to defraud" *Id.* at 381. In *Felton v. Walston and Co., Inc., supra,* this Court dismissed certain claims of fraud which were "merely conclusory" while sustaining others which specified "the agreements and amounts involved in the alleged misrepresentation". 508 F. 2d at 581. In *Segan v. Dreyfus Corp., supra,* the Court, finding a failure to plead fraud with particularity, affirmed an order dismissing a complaint which alleged a course of fradulent conduct lasting several years, but which referred specifically to only one transaction.

The amended complaint, in flagrant disregard of the Second Circuit's mandate, pleads fraud in vague, conclusory terms and upon information and belief which is not supported by a statement of the facts upon which the belief is founded.

Thus, the amended complaint's allegations of "tippee" trading (Am. Compl., pars. 19, 20, 22, A.12-14)*, the heart of plaintiffs' claims, are defectively pleaded in that they are both conclusorally pleaded and pleaded upon information and belief without stating the basis for the belief. Plaintiffs assert as a conclusion that unnamed defendants "tipped" inside information to various unnamed third parties who then sold their holdings in Interstate. Plaintiffs, however, fail to allege the specific facts, such as the identity of the "tippees", the identity of the "tippors", what information was communicated and when it was communicated, which are required by the Rule 9(b) particularity requirement. Clearly such an allegation fails to specify the transaction complained of sufficiently to permit preparation of a defense. Compounding these deficiencies, which alone would render the pleading defective, allegations of "tippee" trading are made upon information and belief. Moreover, this "unmitigated speculation" is unsupported by a requisite statement of the facts upon which the belief is founded. Manifestly, such allegations fail to meet the minimal pleading requirements of Rule 9(b).

In this connection, plaintiffs state as a conclusion that "[T]hese violations were discovered in the course of a Court Hearing before Hon. Judge Cannella of the United States District Court for the Southern District of New York on June 6, 1974." (Am. Compl., par. 26, A.14-15.) Presumably, this unsupported conclusion is meant to supply the source for all of plaintiffs' beliefs with respect to the

*Plaintiffs also raise on this appeal the argument that "tippee" trading is not essential to its claim. However, as is demonstrated *infra* at pp. 19-22, absent insider or "tippee" trading, a mere failure to disclose even material information is not actionable. Since, however, even the allegations of failure to disclose material information are defectively pleaded, it is unnecessary that this Court reach this issue to affirm the dismissal of the amended complaint. See *infra*, pp. 14-17.

claims asserted. This allegation, however, clearly falls far short of the required statement of the facts upon which plaintiffs' information and belief is based. Moreover, the transcript of this court hearing does not even remotely refer to "tippee" trading, or indeed to any trading whatsoever in Interstate securities.

Plaintiffs, in apparent recognition of the complete failure of their alleged source to support their claim, concede on this appeal that they, in fact, have no specific information whatsoever with respect to "tippee" trading (Appellants' Br., p. 6). Indeed, it now appears that plaintiffs' sole basis for this serious charge of wrongdoing is the claim that, "[I]n January 1974 the volume of sales of securities of Interstate Stores, Inc. was far in excess of the normal trading volume" (A.26). Plaintiff's claim of "tippee" trading is thus based only upon the patently absurd conclusion that a high trading volume equals "tippee" trading. It is difficult to conceive of a more blatant violation of Rule 9(b)'s pleading requirements.

Since plaintiffs' assertion of "tippee" trading is essential to its claim, as a result of plaintiffs' failure to allege "tippee" trading with particularity as required by Rule 9(b), the entire amended complaint must fall.

Other essential allegations are also made upon information and belief without stating the facts upon which the belief is founded and are therefore similarly defective. For example, plaintiffs allege on information and belief that defendants knew prior to public disclosure that the proposed merger with McCrory's would not take place (A.12). No facts are alleged to support this belief. Similarly, the belief, unsupported by an allegation of the facts upon which the belief is founded, that defendants knew

five months prior to bankruptcy that bankruptcy proceedings would have to be commenced, fails to meet the pleading requirements of Rule 9(b).* As in *Segal v. Gordon*, these allegations amount to nothing more than "unmitigated speculation."

The allegations that about December 1973 Interstate's trade credit was cut off and that this was material nonpublic information which was required to be promptly disclosed to the public (Am. Compl., par. 15, A.13) also fail to state a claim of fraud sufficient to satisfy the pleading requirements of Rule 9(b). Plaintiffs' conclusion that this "fact" was material nonpublic information is totally without foundation.** The amended complaint states no facts

*As with the claim of "tippee tradi r," the alleged source of plaintiff's conclusions, the court hearing before Judge Cannella, does not offer any support f r either of these conclusions.

**In fact, this information was not a material fact. Interstate's precarious financial condition was well known to the public. For example, published financial statements showed net losses for Interstate of $40,315,000 for the fiscal year ended January 28, 1973; $6,600,000 for the thirteen weeks from January 28, 1973 to April 29, 1973; $20,000,000 for the nine months ended October 28, 1973; and $60,679,000 for the fiscal year ended February 3, 1974. The obvious implications of these statistics were reflected in the low market price of Interstate common stock. As can be gleaned from the amended complaint itself (Am. Compl., par. 6, A. 8-9), Interstate common stock went from the already low price of $2-7/8 per share on January 30, 1974, the date of plaintiffs' first purchase, to the rock bottom price of $10/32 on May 23, 1974, the date of plaintiffs' last purchases. The purchase prices of 4% Convertible Debentures of Interstate, the basis for plaintiffs' Count Two claim, similarly demonstrate the common knowledge of investors that Interstate was hovering on the verge of disaster (Am. Compl., par. 33, A. 17-18). On December 11, 1973 bonds with a face value of $5,000 sold at $625, rendering an effective interest yield of 32%, and on May 23, 1974 bonds with a face value of $10,000 sold at $512.50, for an effective yield of 78%. Thus, Interstate's grave financial woes were well known to the public throughout the period of plaintiffs' purchases. Under these circumstances, it is fatuous to assert, as a conclusion, that Interstate's alleged loss of trade credit was a material fact.

to support this conclusion. Thus, the imputation of wrongdoing is again entirely gratuitous and without foundation.

In like measure, the allegation that defendant Leidesdorf failed to file a required SEC Form 8-K with respect to this event, is defectively pleaded since it is a conclusion unsupported by the underlying facts.* See *Segal v. Gordon, supra,* wherein an allegation that since defendants had formed a "group" to dispose of shares of stock, they should have filed a Schedule 13D Statement, was dismissed for lack of particularity. The court held that since the claim that defendants formed a group was without factual support, it amounted to "unmitigated speculation" and therefore lacked the requisite specificity. 467 F. 2d at 608. Here, under the reasoning of *Segal v. Gordon,* the conclusory allegation that defendant Leidesdorf should have filed a Form 8-K, absent a statement of the facts on which this conclusion is based, amounts to pure speculation and therefore fails to meet the requirements of Rule 9(b).

Moreover, an 8-K report is required only upon the occurrence of an event specified in the items of the form. 3 CCH Fed. Sec. L. Rep. §31,002. Apparently aware that an 8-K report is designed for the disclosure of only certain occurrences, plaintiffs attempt to specify those items of the form which they claim cover the requirement to report Interstates' alleged loss of trade credit (Am. Compl., par. 8, A.10). However, even the most cursory examination of the items specified by plaintiffs—items 4, 6 and 13

*The amended complaint charges only former defendant Leidesdorf with failure to file SEC Form 8-K. However, after Leidesdorf was dropped as a defendant, plaintiffs asserted in their motion papers and now apparently assert on this appeal that the defendants herein are chargeable with this failure. The defendants Cantor and Siegel's argument on this point is thus directed to the extent, if any, to which plaintiffs intend to impose liability upon these defendants for the alleged failure to file this report.

—reveal that they are either plainly inapplicable and unrelated to the alleged loss of trade credit (items 4 and 6) or do not create a duty to disclose (item 13).

Items 4 and 6 are entitled and relate only to "Changes in Securities" and "Defaults Upon Senior Securities", respectively. 3 CCH Fed. Sec. L. Rep. ¶31,003. Item 13, which is entitled "Other Materially Important Events", allows, but does not require, a registrant to report, "at its option", any event not otherwise called for which it deems of material importance to security holders. 3 CCH Fed. Sec. L. Rep. ¶31,003. It is clear that the permissive nature of item 13 creates no affirmative obligation to file an 8-K report with respect to matters not otherwise required to be disclosed.

Finally, it bears reiteration that even assuming any of the claims of withholding material information had been properly pleaded, the amended complaint would still not state a proper claim of fraud since, as demonstrated previously, the allegations of "tippee" trading, a necessary element of such a claim, are defectively pleaded (see *infra* at pp. 13-14).

Manifestly, absent factual particularization of plaintiffs' claim and a statement of the basis for plaintiffs' beliefs, plaintiffs' charges amount to nothing more than conclusory allegations of wrongdoing. Therefore, under Rule 9(b), as a matter of law, the court below was correct in dismissing the amended complaint in its entirety.

POINT TWO

The mere failure to file an SEC Form 8-K report or promptly make a public statement with respect to Interstate's alleged loss of trade credit does not constitute a "securities violation."

Interstate's precarious financial condition during the period in question was and is a clear matter of public record. As pointed out earlier (*supra*, p. 15), the amended complaint shows that Interstate common stock traded at the already low price of $2-7/8 per share on January 30, 1974 and at the rock bottom price of $10/32 per share on May 23, 1974. Interstate's 4% Convertible Debentures sold at prices rendering an effective yield ranging from 32% on December 11, 1973 to 78% on May 23, 1974. Published financial statements indicated that Interstate showed net losses of $40,315,000 for the fiscal year ended January 28, 1973 and $60,679,000 for the fiscal year ended February 3, 1974.

In the face of this public record, plaintiffs allege on information and belief that about December 1973 the normal credit terms given by suppliers to customers was cut off by suppliers of Interstate, putting Interstate on a "C.O.D." basis and that this constituted a material fact which was required to be promptly disclosed to the public* (Am. Compl., par. 15, A.13). Plaintiffs argue that this in-

*In a classic shotgun approach to pleading, plaintiffs allege that the information was required to be disclosed "under the appropriate Securities Act provisions." On briefing the point, plaintiffs assert that the failure to disclose this information constitutes a "Securities Violation" (Appellants' Br., p. 9). Apparently, plaintiff does not want to be pinned down to any particular provision of the securities laws but instead leaves the matter to the imagination of defendants and the Court.

formation was required to be filed in an SEC Form 8-K report or, in the alternative, that absent any specific requirement to report this information and even absent any contemporaneous insider or "tippee" trading on this information, the mere failure to disclose that Interstate had been placed on a "C.O.D." basis by its suppliers constitutes a violation of the securities laws and renders defendants liable to all purchasers of Interstate stocks and debentures during the period of December 1973 to May 1974.

It is, however, clear beyond cavil that the information alleged was not required to be reported in an SEC Form 8-K report (*supra*, pp. 16-17). Neither have plaintiffs pointed to nor does there exist any other rule or regulation relating to securities transactions requiring the filing of such information.

The claim of mere failure to disclose, absent violation of some specific rule or regulation and absent any insider or "tippee" trading, must also be rejected based upon the Second Circuit's "abstain or disclose" rule. *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 848 (2nd Cir., 1968) (*en banc*) *cert. denied sub nom. Kline v. SEC*, 394 U. S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1969). See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F. 2d 228, 236 (2nd Cir., 1974); 2 Bromberg, *Securities Law: Fraud*, §7.4(6)(a), at 178 (1973). As stated in *Texas Gulf*:

> ". . . anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." 401 F. 2d at 848.

Moreover,

> "[A]n insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed'." (citation omitted). *Ibid.*

Significantly, the Securities and Exchange Commission, while urging corporations to make prompt disclosure of material developments, has not stated that failure to do so will create liability in the absence of insider or "tippee" trading. See SEC Sec. Act Release No. 5447 (Dec. 20, 1973) CCH Fed. Sec. L. Rep. ¶79,607 [1973-74 Transfer Binder]; SEC Sec. Act Release No. 5092 (October 15, 1970) CCH Fed. Sec. L. Rep. ¶77,915 [1970-71 Transfer Binder].

Thus, under the circumstances here alleged, a duty to disclose would only arise where: (i) the information in question is reasonably certain to have a substantial effect on the market price of the security and (ii) a person in possession of the material inside information trades on or "tips" the information.

Therefore, even as to material inside information, absent insider or "tippee" trading there is no general, abstract duty to disclose, as here charged, owed by corporate insiders to the public at large. Since, as demonstrated previously (*supra*, pp. 13-14) and as conceded by plaintiffs for purposes of this point (Appellants' Br., p. 9), there is no acceptable allegation of "tippee" trading here, defendants were under no duty to disclose to the investing public the information alleged. Accordingly, plaintiffs'

claim based upon a mere failure to disclose runs *contra* to the law in this Circuit and was correctly dismissed below.

Moreover, it is plain that the alleged inside information here at issue was not, in fact, material information. The fact, as alleged, that Interstate was placed on a "C.O.D." basis by its suppliers could not have had a substantial effect on the market price of Interstate securities. Interstate's precarious financial condition was well known to the investing public. The concept of concealment, inherent in an alleged failure to disclose, is absurd when measured against the consistently declining prices of Interstate's already drastically low common stocks and debentures.

One further point merits mention. It is well settled that the management of a corporation, so long as it acts in good faith, has broad discretion as to actions taken with respect to matters involving "business judgment". *Herald Co. v. Seawell*, 472 F. 2d 1081, 1094 (10th Cir. 1972). See Fletcher, *Cyclopedia of Corporations* §1039 (1965). The efficacy of this rule of long standing, based upon the verities of the corporate decision-making process, is, in effect, challenged by plaintiffs on this appeal. The parameters of management's discretion will be severely circumscribed if the necessity for disclosure and timing of disclosure may be broadly challenged, as plaintiffs here attempt, without any claim whasoever of conflict of interest or any supportable allegation of bad faith.

The "business judgment" rule was recently applied in a decision relating, as here, to a claim of securities fraud. In *Segal v. Coburn Corp. of America*, *supra*, the court in dismissing an amended complaint which, *inter alia*, charged defendants with belated disclosure of a material fact, stated:

> "The action of management, the accountants, the brokers and the public relations firm, which plaintiffs treat as culpable because contradictory of plaintiff's own assertion about what the action should have been, must, in absence of some circumstances fairly supporting an inference of impropriety, be treated as wholly neutral in colloration if not affirmatively entitled to something approximating 'presumption of regularity'." ¶94,002 at 94,021.

As in *Segal v. Coburn,* plaintiffs here have wholly failed to describe any circumstance which can fairly support an inference of impropriety. There is no allegation to overcome the presumption of regularity in management's actions in allegedly failing to disclose the information in question. "Tippee" trading is improperly pleaded. Moreover, from all that appears from the amended complaint, Interstate acted entirely in good faith and had numerous valid reasons, including, perhaps, the protection of shareholders' interests and a desire to keep the corporation running as smoothly as possible under adverse conditions, for not "promptly" disclosing the information in question. This is particularly true in light of Interstate's ominous financial condition, as evidenced by Interstate's drastically low and consistently falling stock and debenture prices.

Accordingly, under the circumstances here alleged, there is no merit to plaintiffs' claim of liability based solely upon an alleged failure to disc'ose.

POINT THREE

The District Court did not err in dismissing the amended complaint without leave to replead.

Plaintiffs argue, without the citation of any authority whatsoever, that even assuming the amended complaint is defective, they are entitled to discovery. (Appellants' Br., pp. 8-9.) It is, however, unclear whether plaintiffs are asserting the right to maintain this amended complaint and to conduct discovery pursuant thereto, even though it is defective, or whether they are asserting, as they did below, that they are in possession of "additional detail" meriting leave to replead. In either case plaintiffs' position is untenable and leave to replead was correctly denied below.

Plaintiffs' request for discovery before stating a well-pleaded claim for relief flies in the face of the clear mandate of the Second Circuit requiring that fraud actions only be brought to redress a wrong reasonably believed to have occurred and *not to find fraud*. *Segal v. Gordon, supra,* 467 F. 2d at 607-08. More recently, this Circuit in *Segan v. Dreyfus Corp., supra,* affirmed a lower court's rejection of a plaintiffs' request for discovery before amending its pleading. The court termed such a request for discovery a "fishing expedition of large proportions." 513 F. 2d at 696. See also *Spiegler v. Wills*, 60 F. R. D. 681, 683 (S.D.N.Y. 1973).

Plaintiffs assert that, even if they are not entitled to discovery on the amended complaint, they are in possession of "additional detail", as revealed in an affidavit submitted below, sufficient to warrant leave to replead as a matter of law. (A.25). The "addiitonal detail" is asserted to be that, "[I]n January 1974 the volume of

sales of securities of Interstate Stores, Inc. was far in excess of the normal trading volume. Thus, obviously, the information involved herein was communicated to favored third parties" (A.26). The plainly frivolous and illogical character of this line of reasoning only serves to support the denial of leave to replead herein.

In effect, plaintiffs now assert that the basis for the claim of "tippee" trading is that the volume of trading increased in January 1974. It is respectfully submitted that such a basis for a claim of fraud is an affront to the dignity of this Court and should not be countenanced by permitting plaintiffs leave to replead so as to assert this "additional detail." Plaintiffs' affidavit only serves to further demonstrate that this action is merely a strike suit and that leave to replead would serve no useful purpose.

Under like circumstances, where leave to replead would serve no useful purpose, this Court has affirmed the denial of leave to replead. In *Segal v. Gordon, supra,* plaintiff's counsel submitted an affidavit, containing a proposed amended complaint, in support of an application for leave to amend the complaint. The proposed amended complaint, however, also failed to comply with Rule 9(b). 467 F. 2d at 609. There was, accordingly, no reason to upset the judgment of dismissal and it was affirmed. Here, plaintiffs' counsel's affidavit constitutes an informal proposed second amended complaint since it states "additional detail" that would allegedly be added to the amended complaint if dismissal is affirmed. This "additional detail", however, falls far short of rectifying the pleading defects of the amended complaint. Accordingly, here, as in *Segal v. Gordon*, there is no reason to upset the lower court's decision to deny leave to replead. Thus, where, as here, leave to replead would constitute an exer-

cise in futility, where plaintiff has stated all that he knows or believes and it is inadequate to state a claim, the district court has discretion to deny leave to replead and thereby bring finality to baseless litigation. See also *Felton v. Walston and Co., Inc., supra,* 508 F. 2d at 582; *Mooney v. Vitolo,* 435 F. 2d 838 (2nd Cir. 1970); *Segal v. Coburn Corp. of America, supra,* ¶94,002 at 94,022.

Conclusion

It is respectfully submitted that for the reasons stated above the District Court's order of July 2, 1975 should be in all respects affirmed.

Respectfully submitted,

PARKER, CHAPIN AND FLATTAU,
Attorneys for Defendants-Appellees,
Sol W. Cantor and Herbert B. Siegel.

Of Counsel:

Alvin M. Stein,
Jordan Newman,
Elliot Cohen.

APPENDIX.

Securities and Exchange Act of 1934, §10b, 15 U. S. C. §78j (1934):

> "SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility o any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Act of 1934, §13, 15 U. S. C. §78m (1970):

> "Section 13. (a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—
>
> (1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12, . . ."

Securities and Exchange Act of 1934, §15, 15 U. S. C. §78. (1970):

> "Section 15 . . . .
>
> (d) Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to the date of enactment of the Securities Acts Amendments of 1964, and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title. . . ."

Securities and Exchange Act of 1934, §18, 15 U. S. C. §78r (1936):

> "SECTION 18. (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any ma-

terial fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. . . ."

Securities and Exchange Act of 1934, §20, 15 U. S. C. §78t (1964):

"SECTION 20. (a) Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.

> (c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this title or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information."

Rule 10b-5, promulgated under §10(b) of the Securities and Exchange Act of 1934, 17 C. F. R. §240.10b-5 (1974):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Securities Exchange Commission Form 8-K, Items 4, 6 and 13:

> *Item 4. Changes in Securities.*
>
> (a) If the constituent instruments defining the rights of the holders of any class of registered securities have been materially modified, give the title of the class of securities involved and state

briefly the general effect of such modification upon the rights of holders of such securities.

(b) If the rights evidenced by any class of registered securities have been materially limited or qualified by the issuance or modification of any other class of securities, state briefly the general effect of the issuance or modification of such other class of securities upon the rights of the holders of the registered securities.

Instruction. Working capital restrictions and other limitations upon the payment of dividends are to be reported hereunder.

Item 6. Defaults Upon Senior Securities.

(a) If there has been any material default in the payment of principal, interest, a sinking or purchase fund installment, or any other material default not cured within 30 days, with respect to any indebtedness of the registrant or any of its significant subsidiaries exceeding 5 percent of the total assets of the registrant and its consolidated subsidiaries, identify the indebtedness and state the nature of the default. In the case of such a default in the payment of principal, interest or a sinking or purchase fund installment, state the amount of the default and the total arrearage on the date of filing this report.

Instruction. This paragraph refers only to events which have become defaults under the governing instruments, i. e., after the expiration of any period of grace and compliance with any notice requirements.

(b) If any material arrearage in the payment of dividends has occurred or if there has been any other material delinquency not cured within 30 days, with respect to any class of preferred stock of the registrant which is registered or which ranks prior to any class of registered securities, or with respect to any class of preferred stock of any significant subsidiary of the registrant, give the title of the class and state the nature of the arrearage or delinquency. In the case of an arrearage in the payment of dividends, state the amount and the total arrearage on the date of filing this report.

Instruction. Item 6 need not be answered as to any default or arrearage with respect to any class of securities all of which is held by, or for the account of, the registrant or its totally held subsidiaries.

Item 13. Other Materially Important Events.

The registrant may, at its option, report under this item any events, with respect to which information is not otherwise called for by this form, which the registrant deems of material importance to security holders.

375—Affidavit of Service The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

THE UNITED STATES COURT OF APPEALS

SYLVIA SACKS et al

vs

INTERSTATE STORES

AFFIDAVIT OF SERVICE

STATE OF NEW YORK,
COUNTY OF NEW YORK ss:

BERNARD S. GREENBERG being duly sworn,

deposes and says that he is over the age of 21 years and resides at 261 7th st, NY, NY

That on the 28th day of November, 1975 19 at

he served the annexed brief for defndantts-appellees Cantor & Siegel upon I?. Walton Bader, attorney for the plaintiffs-appellants, 270 Madison avenue, NY, NY in this action, by delivering to and leaving with said attorneys three true cop thereof.

DEPONENT FURTHER SAYS, that he knew the person so served as aforesaid to be the person mentioned and described in the said

Deponent is not a party to the action.

Sworn to before me, this 28th day of November, 1975 19

Bernard S Greenberg

Roland W. Johnson

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4609705
Qualified in Delaware County
Commission Expires March 30, 1977